FILED

NO. 824

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

W. A. THOMAS, Collector of Internal Revenue,
Petitioner,

versus

J. J. PERKINS, ET AL, *Respondents.*

On Writ of Certiorari to the United State Circuit Court of Appeals for the Fifth Circuit.

RESPONDENTS' BRIEF

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RESPONDENTS' BRIEF

Opinions Below

The opinion of the Circuit Court of Appeals is reported at 86 Fed. (2d) 954 (R. 96). The opinion of the District Court is reported at 15 Fed. Supp. 356 (R. 15).

Jurisdiction

The judgment of the Circuit Court of Appeals was entered December 18, 1936 (R. 100). The jurisdiction

of this Court was envoked by Petitioner under Section 240(a) of the Judicial Code amended by Act of February 13, 1925. Petition for Certiorari was filed on March 17, 1937, and Certiorari granted on April 5, 1937 (R. 101).

Statutes Involved

The Federal Taxing Statutes involved will be found in the appendix, *infra* page 68.

Statement of the Case

This case involves the question of whether under the Revenue Act of 1932 the Respondents can be required to include, as their gross income, without an offsetting deduction, so much of the oil produced from certain leases operated by them, or the proceeds from the sale thereof, as went to their immediate assignors, in accordance with a provision in the assignment to them that one-fourth (1/4th) of the oil produced was to go to their assignors until they had received a specified sum, or oil of a specified value. Such a contractural arrangement is customarily referred to as an "oil payment" and this term will be frequently used hereafter.

The Respondents are husband and wife, joined here because the income dealt with is community income. Since no question relating to this is involved, Mrs. Perkins' connection with the matter will be disregarded and her husband alone referred to hereinafter.

Likewise, the assignment in question (Exhibit 1, R. 21) runs to Faith Oil Corporation. This Company

was owned principally by Perkins and one W. J. Green. In taking the assignment Faith Oil Corporation acted for itself to the extent of one-fourth (1/4th) of the interest acquired; for W. J. Green to the extent of three-eights (3/8ths), and for Perkins to the extent of three-eighths (3/8ths) of the interest acquired (R. 21). The interest so acquired in trust by Faith Oil Corporation was later conveyed to Perkins (Exhibit 5-A, R. 27). Since these facts, too, are immaterial here, we will disregard the joint interest of Faith Oil Corporation and Green with Perkins and treat the matter as if Perkins had been named as the sole assignee in said Exhibit No. 1.

Thus qualified, the pertinent facts are:

Mamie S. Hammonds and Fred P. Branson owned certain oil and gas leases on valuable, but at that time undeveloped, lands in the East Texas Oil Field. They held under ordinary commercial leases providing for the customary one-eighth royalty on oil. These leases are in the Record (Ex. 2, R. 23; Ex. 3, R. 27; Ex. 4, R. 27). On July 24, 1931, they executed an assignment of these leases to Faith Oil Corporation (but for the benefit of that corporation, Green and Perkins, as heretofore stated). The cash consideration recited was Ten Dollars (R. 21), but the actual consideration then paid was One Hundred Five Thousand ($105,000.00) Dollars in cash and Fifty Thosusand ($50,000.00) Dollars in notes, which were later paid (R. 27).

The assignment provided that Branson and Hammonds

"• • • do hereby bargain, sell, transfer, assign and convey all our rights, title and interest in and to said leases and rights thereunder."

But, in stating the consideration, it was provided that the instrument was executed:

"In consideration of the sum of Ten ($10.00 Dollars cash in hand paid by Faith Oil Corporation, a Texas corporation, and of the further sum of $395,000.00 *to be paid out of the oil produced and saved from the hereinafter described lands, and to be one fourth (1/4th) of all the oil produced and saved from the premises hereinafter described until the full sum of* $395,000.00 *is paid.*" (All emphasis throughout is ours unless otherwise noted.)

And, after the granting clause and description of the lands and leaseholds, the instrument further provided:

"As hereinbefore stated, Three Hundred Ninety-five Thousand Dollars ($395,000.00) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one-half thereof, *out of the oil produced and saved from said leased premises,* which payments shall be made by the pipe line company or other purchaser of said oil, and shall be one-fourth (1/4th) of all the oil produced and saved from the above described land, until the full sum of Three Hundred Ninety-five Thousand Dollars ($395,000.00) is fully paid, *which oil payments shall be made direct to the same Mamie S. Hammonds and Fred P. Branson, or their heirs and assigns, one-half to each, by the purchaser or purchasers of said oil, when and as the same is run.* It is under-

stood and agreed that the said Three Hundred Ninety-five Thosuand Dollars ($395,000.00) *is payable out of oil only, if, as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee*, its successors or assigns, nor impose any implied obligation with respect to drilling or development, except in contract of June 30, 1931, the intention being that said Three Hundred Ninety-five Thosusand Dollars ($395,000.00) *shall be paid only out of and to the extent of the proceeds of one-fourth of the oil produced and saved from said premises, if, as and when produced.* It is further agreed and understood that the oil payment herein specified shall bear none of the expenses of the development of said leases or any other burden."

The instrument contained the customary warranty of title. It did *not* purport to reserve or retain any lien (Ex. 1, R. 21-23).

Perkins and associates thereafter developed certain of the leases assigned, drilling twenty-two wells on one lease and eight on each of two others. (R. 31).

In 1933, the tax year here involved, they continued to operate the property and produce oil therefrom, so that Branson and Hammonds received substantial amounts to apply upon their oil payments.

The method of operation was to run the oil from the various wells into tanks upon the various leases, from which tanks the oil was taken by the Pipe Line Companies running and purchasing the oil. Each Pipe

Line Company required and was furnished a division order executed by all parties at interest, including the royalty owner and his assigns. The Pipe Line or Oil Purchasing Company then made periodic payments for the oil run from the properties, making such payments directly and proportionately to interest to the parties executing the division orders. So, at all times, the royalty owner, or his assigns, received payment directly from the Pipe Line Company for their share of the oil, as did Branson and Hammonds and Perkins and the others concerned. At no time did Perkins, or his associates, receive one dollar of the proceeds from the sale of so much of the oil as was applicable to the oil payment.

There are several typical division orders in the record. For example, that addressed to Simms Oil Company (R. 39) is executed by Faith Oil Corporation, Mrs. Hammonds and husband, and Branson. The royalty owners are omitted, evidently because they signed a separate division order. At the date of this instrument, June 17, 1932, record title had not been divided between Faith Oil Corporation, Perkins and Green. The instrument begins:

> "The undersigned *certify and guarantee that they are the legal owners of wells, numbered one and up on the Faith Oil Corporation—J. C. Barret Farm* • • • and until further written notice you are authorized for your own account to receive oil therefrom into your possession, or the possession of any person or corporation designated by you, giving credit as directed below:

Credit to	Division of Int.	P. O. Address
Faith Oil Corporation	20/32 W. I.	Wichita Falls, Texas;
Mamie S. Hammonds and		623 E 18th St. Okla. City, Okla.
Fred P. Branson (One-half each)	8/32 W. I.	Skirvin Hotel, Okla. City, Okla.

Until they receive the sum of $395,000.00 out of the J. C. Barrett and other leases.

Simms Oil Company is hereby authorized until further notice to receive oil from said wells for purchase from the said parties severally in the proportions named, subject to the following conditions:

First: That oil run in pursuance of this division order shall become the property of Simms Oil Company as soon as the same is received into the custody of it or its designated agent.

Second: *The oil received in pursuance of this division order shall be paid for to the party or parties entitled thereto according to the division of interests shown above, at such price as Simms Oil Company is currently willing to pay for oil received from the above described lease on the day of receipt thereof.* Notices of your current price basis and any changes therein are to be addressed to the undersigned at the respective post office addresses shown above. Payments to be made monthly by checks mailed to said party or parties at their respective addresses above set out.

• • • • • • • •

Fourth: The undersigned agrees to furnish Simms Oil Company with satisfactory abstracts and other evidence of title at any time on demand and in event of failure to so furnish such evidence

of title, or in case of any adverse claim of title, to furnish to Simms Oil Company upon demand a suitable and satisfactory bond executed by a surety company authorized to do business in Texas, indemnifying Simms Oil Company against such claim or claims, and that Simms Oil Company may retain the purchase price of the oil without interest until furnished such bond or until the dispute as to ownership is settled satisfactorily to said company.

* * * * * * * * *

(Signed) Faith Oil Corporation, Inc.,
W. J. Green, President,
Mamie S. Hammonds,
O. O. Hammonds,
Fred P. Branson."

Under customary oil field practice, Perkins and associates could not have collected for any portion of the oil applicable to the oil payment, except with the written consent of Branson and Hammonds (R. 48).

At the time of the trial, Branson and Hammonds had received approximately one-half of what was coming to them under the oil payment, and it was then probable that they would receive the balance within the next two and one-half years (R. 48). The first oil had been produced in 1931 (R. 31), so it will be approximately the close of 1938 before Branson and Hammonds receive all their share of the oil.

In making his tax return for 1933, Perkins did not include as his income so much of the oil, or its proceeds, as went to Branson and Hammonds, but, upon audit of these returns, these amounts were so included by the taxing authorities (R. 48). In so doing, percentage de-

pletion was allowed against the additional amounts so included, which of course Perkins had not claimed because he had not included these amounts as a part of his gross income. The theory upon which the Commissioner acted is disclosed by the following excerpt from his letter rejecting the refund claims: (R. 61)

> "A review of the case discloses that in accordance with the terms of the contract, whereby a working interest in certain East Texas oil and gas leases was acquired for cash and additional payments to be made out of a fraction of the oil produced, oil payments of $19,229.03 made during 1933 have been included in taxable income subject to percentage depletion and also in leasehold cost returnable through cost depletion. This action is in accordance with the decision of the United States Circuit Court of Appeals for the Eighth Circuit in the case of the Comar Oil Company, 64 Fed. (2d) 965, certiorari denied by the United States Supreme Court, 54 S. Ct. 69, in which it was held that where certain oil and gas leases were transferred to the petitioner by assignments in consideration for a certain amount of money to be paid partly in cash and partly out of oil and gas as produced from the leased property, the royalties paid as deferred payments in 1923 constituted taxable income to the petitioner and also represented capital transactions not deductible as expenses. The treatment of this item in the revenue agent's report is therefore approved by this office."

Perkins paid the tax, filed claims for refund and, upon their rejection, instituted suit in the United States District Court for the Northern District of Texas

against the Collector to whom the payments were made. The record presents no question as to compliance with the requirements requisite to bring the suit.

In the Trial Court it was proven that the long established practice of the Bureau of Internal Revenue, was not to require the operator of an oil and gas lease to include, as a part of his income, the royalties payable in kind to the lessor; that where royalties were payable in cash the operator included the proceeds from the sale of all the oil, but took as an offsetting deduction the amount of the royalties paid. (R. 65-66; 75-76).

The Respondents made their income tax returns upon a cash receipt and disbursement basis. (Alleged (R. 5); admitted (R. 10).) The Respondents admitted that, if they prevailed in their contention that the sums going to Branson and Hammonds should not be included in their income, the depletion allowed them should be correspondingly reduced (R. 59).

The Trial Court held against Perkins' contention that the amounts which went to Branson and Hammonds should be excluded from his income. The Trial Court treated the oil payments as a debt; the assignment in question as conveying to Perkins and associates the entire leasehold, and all oil applicable thereto. As stated by the Circuit Court, the Trial Court preferred the reasoning of the *Pugh* case (5th C. C. A.) 49 Fed. (2d) 76, and the *Comar Oil Company* case by *the Eighth Circuit*, 64 Fed. (2d) 965, to the later decision of the Fifth Circuit in the *Fleming* case 82 Fed.

(2d) 325. The Trial Court indicated that Branson and Hammonds as well as Perkins might be allowed depletion with respect to the sum in question.

Upon appeal, the Circuit Court treated the matter as concluded by its decision in the *Fleming* case and this Court's decision in the *Palmer* case, and recognized that its *Pugh* and *Palmer* decisions had been overruled by this Court's decision in *Palmer v. Bender.* That Court held, in substance, that Branson and Hammonds were not creditors; that what they received was income from the production of oil and not purchase money; that Perkins owed them only the duty to submit to a division of the proceeds derived from the mining operation and that, to be consistent, the matter should be decided in accordance with the principles which it had applied in its recent decisions involving depletion.

Upon the Government's claim that this opinion conflicted with that of the 8th Circuit Court in the *Comar Oil Company* case, *supra*, this Court granted certiorari.

SUMMARY OF ARGUMENT

I

That portion of the oil produced, or the proceeds from the sale thereof, which went to Branson and Hammonds, cannot be included in Perkins' gross income because it did not belong to him, either practically or legally.

II

Those decisions which hold that taxpayers similarly

situated to Branson and Hammonds are entitled to an allowance for percentage depletion based upon the amount which they receive to apply upon such oil payments are decisive of the question; for, to reach that conclusion, it must be determined that such sums are gross income derived by such oil payment holders from the extraction of the oil or gas. No sum can simultaneously be the income of two taxpayers from the same source. This Court's decision in *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, compels the same conclusion.

III

The *Comar Oil Company* case—apparently conflicting with the decision below—presents some substantial factual differences, and, in any event, it was based upon a serious misconception of fundamental tax practices and of applicable statutory provisions, and its conclusions are not supported by the authorities cited in the opinion. The basic holding of this Court in the *Palmer* case was misunderstood.

IV

It is now recognized that the *Pugh* case and other similar cases, upon which the Government must rely here, were in effect overruled by this Court's decision in the *Palmer* case.

V

Various other well established principles support the decision below.

VI

The economic consequences of a holding favorable to the taxpayer were misunderstood by the Trial Court.

VII

Petitioner's brief does not meet the issues involved, and the authorities cited do not support his conclusion.

ARGUMENT

I

Our basic contention is that Perkins never acquired an interest in so much of the oil as will be necessary to satisfy the "oil payment" of such a nature as to constitute the delivery of the same by him in accordance with the contractual requirement, a part of his gross taxable income. This is *not* solely because of Texas theories about ownership of oil in place. In Texas, the Courts might justify the conclusion because there title to so much of the oil as was and will be necessary to satisfy the oil payment never passed to Perkins. In other States, for example, Louisiana, (selected because the property in *Palmer v. Bender* 287 U. S. 551, was located there), the conclusion would be justified because Perkins never acquired "legal control" of that much of the oil. We submit that the controlling reason is that, under the practical view adopted in tax matters, Perkins did not own sufficient "rights" in the oil or its proceeds to constitute the same, upon production and disposition, his income. Perkins should not be taxed with respect to this oil because he did not own it, either from

the standpoint of State law or when viewed from the standpoint of Federal taxation.

If Perkins derived any taxable gain from the one-fourth of the oil produced which went to Branson and Hammonds, this gain must be reported and taxed because of the all-inclusive definition of "gross income" [1] in the statute; if not, he should not, and cannot, be taxed thereon because, although all "gain" is included in the definition, nothing but "gain" is included.[1a]

If Perkins' relation to this oil was that of an owner, and his relation to Branson and Hammonds that of a debtor, then it would follow, necessarily, that the production and delivery of this oil to apply on his obligation was an income producing transaction. We do not contend that actual physical receipt of income is necessary to support a tax thereon; we recognize that the "short-cut" method of payment by the purchaser of the oil to Branson and Hammonds would produce

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[1] Section 22(a) Revenue Act of 1932, set out in full at page 68 Appendix.

[1a] Because the basic factor in the concept of income is ownership, no single item can, we submit, be simultaneously the income of two people. The principles applied to determine the taxability of assigned income, discussed by this Court in its recent decision of *Blair v. Commissioner*, ... U. S. ...., decided Feb. 1, 1937, do not conflict with this. Thus if the holder of a debt is assigned the rent from a building to pay interest due him, both he and the debtor who owns the building receive income by the short-cut process of paying the rent directly to the holder of the debt, but only one receives "rent,"—the other receives "interest." The building owner has an off-setting deduction for interest paid.

income to Perkins if it were *his* oil so paid for, and if the proceeds were applied upon *his* debt. But, by precisely the same line of reasoning, if this one-fourth of the oil did not belong to him, if he did not owe a debt to Branson and Hammonds, and receive credit thereon through the sale of this oil, he cannot be taxed thereon.

There are three tests that might be applied to solve this question:

(1) The principles which would be applied by Texas Courts;

(2) The principles which would be applied in other States where different theories are applied to transactions relating to oil and gas; and

(3) The practical view, capable of nation-wide application, which this Court has consistently applied in passing upon Federal tax problems.

We believe the same result is reached under each of these tests.

First, it should be observed that the Government's basic contention is that, by virtue of the broad language in the granting clause of the assignment, Branson and Hammonds parted with all of their ownership rights in the leaseholds and the oil to be produced therefrom, and converted their position into that of a creditor entitled to receive, contingently, a debt payment.

Under Texas law, this position cannot be supported. The question has ordinarily arisen in the interpretation of leases, as distinguished from assignments or subleases, and chiefly in connection with ad valorem tax

cases. Such instruments employ varying terms:—Some "let and lease" the land for mining operations; some "bargain, grant, sell and convey" all of the oil and other minerals, with the right to use the land for mining purposes; some provide for a royalty payable in kind, some for cash measured by the value of a specified fraction of the minerals; some give the lessee the option to pay royalties in kind or in cash; some treat the royalty as a reservation, some as a payment back; practically all refer to the royalty as the consideration, or a part of the consideration, for the grant.

At one time, the applicable decisions were somewhat confused and there was plausible support for the proposition that, if the lessor did not expressly reserve a portion of the oil, title to all of the oil passed to the lessee. That was the state of the decisions when *Waggoner Estate v. Wichita County*, 273 U. S. 113, was before this Court and, no doubt, led to the expression in that opinion to the effect that title to all of the oil passed to the lessee.[2] But the situation has now been

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[2] The *Waggoner Estate* case was decided by this Court on January 3, 1937. This Court referred to *Stephens County v. Mid Kansas Oil & Gas Company*, 113 Tex. 160, 254 S. W. 290, and said (page 118):

> "In the absence of controlling authority in the Texas Courts, we can find in the terms of the leases themselves no basis for the contention that the lessor granted or conveyed away his entire interest in the oil. The case of *Stephens County v. Mid-Kansas Oil & Gas Co.*, supra, is relied upon by appellants, but in that case the lease, similar in other respects to those now under consideration, provided that the lessee at his option should pay the stipulated royalties in oil or

clarified by the Supreme Court of Texas in *Sheffield v. Hogg*, 124 Tex. 290, 77 S. W. (2d) 1021, and it is settled that regardless of verbiage, the grantor in such an instrument has and retains an interest in the minerals equivalent to the share which he is to receive, or which measures his cash payment.[3] The same result was

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cash. It thus conferred on the lessee the essentials of ownership—possession, with unrestricted power of appropriation and disposition of the oil. The lessee was therefore properly taxed as owner."

We point out, in this connection, that the question in the *Stephens County* case was whether the Oil Company was taxable upon its interest under the oil and gas lease as real estate. The question of whether the royalty owner was also taxable upon his interest in the lease as real estate was not directly involved.

[3] In *Sheffield v. Hogg, supra*, the lease in question purported to "transfer and set over, sell and convey (under the terms and conditions hereof and for the period and purpose herein set forth) all of the gas, oil, sulphur and other minerals and mineral substances on, in and under the hereinafter described land." The royalty provision was that the lessor should "have the following royalty on the gross production of oil or gas wells on said land, to-wit: one-eighth of all oil and one-eighth of all gas, and the first party's one-eighth royalty interest in the oil and gas manufactured from said land to be paid over to him by second party at the end of each month, or whenever second party shall receive pay therefor."

The basic contention of the Hogg heirs in this case was that the value of their royalty interest under this instrument could not be taxed to them as real estate in the County where the land was situated. But the Supreme Court denied this contention for reasons which are controlling here. The Court said:

reached by the Supreme Court of Texas when it considered a warranty deed purporting to convey the land in fee simple, but providing that the grantor was to re-

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"Endeavoring to reach the true purpose and intent of parties, we can draw no substantial difference, so far as taxation is concerned, between an agreement *excepting* from a grant or a lease a certain fractional portion of minerals, or an agreement *reserving* the same portion, or an agreement that the lessor '*shall have*' or, rather *shall continue to have* the same portion, or an agreement that the lessees *shall yield or shall deliver to the lessor* exactly the same portion. In either instance, the title to the specified mineral portion is intended to remain or vest, and does actually remain or vest, in the lessor. It logically can make no difference, as may have been intimated in this justice's and in other far greater jurist's reasoning, whether the oil is retained by the lessor as oil and gas, readily convertible into cash on the market, or whether the lessee is given a power to sell *all* of the oil or gas, always accounting for a fixed royalty portion to the lessor. Sound principle, supported by the highest authority, goes further and compels us to accede to the proposition that dealing with oil and gas or dealing with solids in place, like sulphur, lignite, salt, coal or lime, the lessor owning the entire fee-simple title to the land, and his assigns, who may have been careful to secure to themselves, their heirs or assigns (by exception or reservation or by contract for '*having*' or yielding or paying, or for delivery, or by what-not-similar contractual clause), the right to a portion of the proceeds or profits derived from the lessee's or his assigns' authorized sale of the minerals, throughout the duration of a determinable fee, which may be perpetual, have and own a fee simple interest in land, or at least have a right belonging or appertaining to the horizontal strata of the land in which the minerals are embedded. • • • •

ceive a certain share of the oil, if the grantee or his assigns subsequently developed the property.[4]

• • • • We therefore hold that all the property interests of ascertainable value, secured to the lessor or their assigns under the Hogg-Hamman lease, are subject to taxation as real estate in the county wherein the land lies, as adjudged by the District Court." (Italics by the Court.)

An examination of the following cases: *Texas Co. v. Daugherty*, 107 Tex. 227, 176 S. W. 717; *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290; *Hager v. Stakes*, 116 Tex. 453, 294 S. W. 835; *Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 517, 19 S. W. (2d) 27; *Reynolds v. McMans Oil & Gas Co.*, 11 S. W. (2d) 778, by the Commission of Appeals, in connection with *Sheffield v. Hogg, supra*, will show how the theory under discussion was developed by the Texas Courts and finally fixed as shown in the above quotation from *Sheffield v. Hogg.*

[4] See *Hager v. Stakes*, 116 Tex. 453, 294 S. W. 835. We believe that the construction placed by the Supreme Court of Texas upon the deed involved in this case (there were several instruments besides the deed under consideration) announces a correct and controlling principle of construction, in addition to illustrating the Texas rule under discussion. This deed was to J. M. Guffey Petroleum Company. It recited a cash consideration paid and the further consideration of "one-eighth of seventeen-eighteenths of all petroleum which said J. M. Guffey Petroleum Company, its successors and assigns hereunder may produce and save from the land above described, such portion of the petroleum to be delivered free of expense to me, the said Lee Hager, my heirs or assigns, at the well or at my or their option to any pipe line which may connect to the well." Hager owned a 17/18ths interest in the land prior to the execution of the deed and the Supreme Court announced its

The Texas case most directly in point, because it involves an "oil payment" rather than ordinary royalties, is *Dunn v. Tennant*, 82 S. W. (2d) 728, now pending in the Supreme Court of Texas on writ of error. It was there held that an instrument, executed in consideration of money advanced to a lessee, which provided that one advancing the money was to receive a fraction of the oil until oil of a specified value, materially exceeding the amount of money advanced, had been received, conveyed an interest in the land and did not create a debtor-creditor relationship. This case is all the more convincing because the rights did not arise in

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conclusion that the deed "does not grant or convey all of the grantor's undivided seventeen-eighteenths of the petroleum in this 150 acres of land, despite the positive terms of the granting and habendum clauses." This, the Court said, was because the instrument disclosed that its "dominant purpose" was to make impossible any disposition of the 1/8th of 17/18ths of this oil, except its delivery to Hager or his assigns. "Hence no matter how poorly expressed, their being words disclosing such purpose, there is excepted from the grant 1/8th part of 17/18ths of the petroleum. It is obvious that the instrument negatives the view that the obligation to deliver a portion of the oil was intended to be a mere personal covenant of the lessee or its assigns. Likewise, the obligation was not meant to inure to the personal benefit of the lessor. It was meant to benefit the owner of an estate in the land and to run permanently with the land."

So, in our case, the covenant in favor of Branson and Hammonds ran with the land. Perkins, as well as the original party to the instrument, Faith Oil Corporation, could assign their interests and be freed from all further obligation.

a conveyance or assignment in the chain of title.[5] This case was cited with approval by the Fifth Circuit in *Berry v. Harrell*, 83 Fed. (2d) 671.

These Texas decisions furnish an appropriate guide for the interpretation of the instrument before this Court. It is primarily a problem of conveyancing and construction. Under the decisions referred to above, controlling effect cannot be given to any one clause in the instrument. It must be looked at in its entirety, and if such an examination shows that, after execution and delivery of the instrument, the grantor still retains the exclusive right to a share of the oil, or the exclusive right to the proceeds from a sale of that share of the oil; he has not sold that much of the oil but continues to be the owner thereof. So tested, Perkins did not acquire, and Branson and Hammonds did not sell, one-fourth of the oil.[6]

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[5] Clearly under Texas Law Branson and Hammonds, prior to the assignment to Perkins owned 7/8ths of the oil under the land. Necessarily, they continued to own all with which they did not part under a fair construction of the instrument. In *Dunn v. Tennant*, the lessee there likewise owned all of the lessee's share of the oil and gas and, clearly, his dominant purpose was to secure and repay an advance of money made by Mrs. Dunn, who had no previous connection with the title.

[6] As illustrated by *Texas Company v. Daugherty*, 107 Tex. 226, and *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Tex. 160, 168, a conveyance of oil in place may be made either by an instrument which expressly so states, or by one which confers rights of possession, use and enjoyment. Texas Courts merely look at the substance and now hold that each creates a

If we examine the question in the light of the decisions of those States which do not recognize that oil or gas in place is capable of transfer and sale apart from the fee, we arrive at the same result from a tax standpoint. Under such a theory, the lessee did not acquire title to the oil in place, so, regardless of verbiage, he could not sell it. Under this theory, title to the oil in place remains in the lessor. The lessee acquired the

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determinable fee. See cases cited foot note page 19 hereof. Also *United States v. Noble*, 237 U. S. 74, 80. Prior to the execution of the instrument, Branson and Hammonds had obtained from the lessor the right of possession for oil purposes and rights in or ownership to 7/8ths of the oil. They transferred to Perkins their right to possession, and gave him control over development and producing operations—just as the lessor had given them control over these operations, but they did not give him the right to appropriate or in anywise dispose of 1/4th of the 7/8ths of the oil, and he, therefore, never acquired from them ownership of this oil any more than they, in turn, had acquired ownership of the 1/8th royalty from the landowner by virtue of the original lease. Perkins did not have what this Court termed the essentials of ownership in the *W. T. Waggoner Estate case*, supra: "Possession, with unrestricted power of appropriation and disposition of the oil." Perkins has possession, but his power of disposition and appropriation was limited and did not include either the royalty owner's 1/8th or Branson and Hammond's 1/4th. There was a subdivision of ownership—not a complete transfer, and while it is probable that Branson and Hammonds' interest in the oil will be terminated prior to that of the royalty owner, it is possible for their interest to last equally as long. This possibility of termination is what makes the estate a determinable fee. *Tiffany on Real Estate*, (2nd Ed.) Sec. 93, Note 73.

exclusive right to operate and to appropriate, when produced, a specified portion of the oil. To this oil, he acquires title when produced. But here, by the self-same instrument by which Branson and Hammonds transferred to Perkins control of operations. they expressly, and in the clearest possible language, provided that, when and as the oil, then undiscovered and unproduced, reached the top of the ground and became, under this theory, capable of ownership and division, one-fourth should be delivered to their credit in exactly the same way that the royalty owner was to receive his share. At no point of time did Perkins have or acquire the rights of an owner as to this portion of the oil. He was obligated to produce it with his own share, but in no way could he benefit by it.[7]

This Court has always refused to apply peculiar State laws to Federal Taxing Statutes of national application, when the taxing statute contained its own standards and criteria. *Burnet v. Harmel*, 287 U. S.

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[7] Of course, when reference is made to an estate in land, it is merely descriptive of the rights which the holder of that estate has. *Tiffany on Real Estate*, Sec. 2, pp. 4-6. The right of Branson and Hammonds to 1/4th of the oil could be conveyed by them or taken in execution against them, and Perkins could not cut these rights down. The right continues for an indefinite term and may continue as long as oil will be produced. In just the same way that he who has the profits of the land owns the land, we say that he who retains a share of the profits of the land retains an interest in the land. *Tiffany on Real Estate* (2d Ed.) Vol. 2, Page 1647, 1648; *Green v. Biddle*, 8 Wheat 75, 76; *Caldwell v. Fulton*, 31 Pa. St. 484, 71 Am. Dec. 760; *Lynch v. Alworth Stephens Company*, 267 U. S. 364.

103, is an example. Cf. *Poe v. Seaborn*, 282 U. S. 101, and *Hopkins v. Bacon*, 282 U. S. 122. Especially has this Court applied this principle in tax cases involving oil or other minerals. Thus, in *Lynch v. Alworth Stephens Company*, 267 U. S. 364, this Court refused to let the fact that under Minnesota law, a lessee, who had sub-let ore lands for cash royalties, might not own any of the ore in place, prevent this Court from recognizing that he had a valuable property right which was depleted by the production of the ore, entitling him to a depletion allowance based upon his income from the property. The same disregard of technical distinctions and the terminology employed by State Courts was shown in *Palmer v. Bender*, 287 U. S. 551, discussed fully elsewhere. And this Court has, on many other occasions, disregarded "refinements of title" and looked, instead, at the practical situation, the actual benefits and the actual command which the person claimed to be taxable might exercise over the property or fund taxed.[8] We venture to say that the use by this Court in the *Palmer* case of the phrase "economic interest" was prompted by a desire to view the matter broadly and practically, and to establish a standard which could not be varied because of the differing views which State Courts might take of the situation, and the various classifications which they might make of the parties and their rights.

Looking at the present situation from this stand-

[8] *Tyler v. United States*, 281 U. S. 497; *Corliss v. Bowers*, 281 U. S. 376; *United States v. Robbins*, 269 U. S. 315; *Douglas v. Wilcutts*, 291 U. S. 1.

point, we find that Perkins had no "rights" in the one-fourth of the oil applicable to the Branson-Hammonds oil payment. Perkins' conveyance would give no one control of or economic benefits from that one-fourth of the oil. He could not mortgage it; he had no equity in it. It could not be taken for his debt. He could not sell this one-fourth of the oil as produced. The instrument did not give him this right; the long-established custom in the oil business recognized this and the signature of Branson and Hammonds to the "division order," (actually the contract under which the oil was sold) was always required. A recognized test to determine ownership is to determine upon whom the loss would fall if the subject matter of the test were lost or destroyed through no fault of any one.[9] Clearly, in such a case, the loss would fall on Hammonds and Branson. Mr. Justice Holmes used the test of determining for whose debt the property could be taken.[10] Ownership, without rights such as these, is an impossible conception, and when these rights are fixed in one person under a fair construction of the instrument, no language can vest real ownership in another.[11]

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[9] See Judge Dawkins's dissenting opinion in *Herold v. Commissioner*, 42 Fed. (2d) 942. We believe that the theory developed by Judge Dawkins in this case, which was closely related to the Palmer case on the facts, also closely accords with the theory upon which this Court later decided the Palmer case.

[10] *United States v. Robbins*, 269 U. S. 315 (The first California Community Property Income Tax case).

[11] "The general power of disposal without liability to account, is equivalent to ownership itself." *Caldwell v. Fulton*, 31 Pa. St. 483, 488, 71 Am. Dec. 760.

Each right of ownership that Perkins did not have —and he had none whatever, we submit—was in Branson and Hammonds. They could sell the right to receive the oil, they, only, could, and did, sell the oil when produced; they, only, could, and did collect for it; the interest involved was subject to seizure and sale for their debts. True, Perkins had the burdens of producing, just as he had the same burdens with respect to the one-eighth royalty—but benefits, not burdens, determine ownership.

Nor can it be fairly said that Perkins' burdens and the benefits accruing to Branson and Hammonds arose out of a debtor-creditor relationship and some thing equivalent to a pledge or lien. Certainly there was no express lien or pledge. Nor was there any personal obligation to pay or cause to be paid. If, after a fair test, oil had not been found, Perkins could surrender the lease without liability.[12] One cannot so relieve himself of a debt, we are certain. Without a debt, there can be no lien or pledge. Any debt can be paid prior to maturity, if the payor seeks no discount. But this agreement, binding on both parties, said the payments were to be made "*only* as, if and when oil was produced." Branson and Hammonds could have refused cash, and in many cases, because of wide differences in tax liability, a tender of cash would be refused. Progressive

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[12] *Owens v. O'Donohoe*, 280 S. W. 842, *Greenwood & Tyrrell v. Helm*, 264 S. W. 221; *Ferris v. Huffman*, 274 S. W. 125, by Commission of Appeals; *Collins v. Atlantic Oil Producing Company* (5th C. C. A.), 74 Fed. (2d) 122.

surtaxes and depletion allowances would in many cases make such a refusal extremely profitable.

We submit that, from a practical standpoint, the situation now before the Court is like that of a share-cropper. The tenant who agrees to deliver one-fourth of the cotton produced, or one-fourth of the proceeds from its sale, is not considered a debtor in the ordinary sense of the term. He has the burdens, he has a large measure of control, he may be authorized to sell and collect the proceeds, but as long as no obligation arises, except as and if crops are harvested, and then only to the extent of a share of the harvest; if he must submit to a division of the proceeds, but need not make up any deficiency, he is not a debtor. And, most important, no one has ever suggested that such a tenant must include the proceeds of the crop accruing to his landlord as a part of his—the tenant's—gross income and that, if he adopted a system of accounting under which this was done, he would not deduct as a current expense, the crop rents so paid.

In final analysis, the question is to be determined by fundamentals—who derives income from, who obtains and owns gain from the one-fourth of the oil? Gain, without ownership cannot exist.[13] The gain is the in-

[13] In *Eisner v. Macomber*, 252 U. S. 189, this Court not only said that income was the gain derived from capital, from labor, or from both combined, but this Court went on to say that such gain must be derived by the taxpayer "for his own separate use, benefit and disposal." Here Perkins owed no debt to Branson and Hammonds (See the authorities cited in foot note 12), and, certainly, he derived no benefit from, and he could

come "of" that person who so owns it.[14] This Court has frequently so held,—applying the principle that taxes are usually, if not necessarily, imposed by reason of ownership.[15] As late as January of this year, this Court again applied the principle, saying:

> "In the instant case, the tax is upon the income as to which, in the general application of the Revenue Acts, the tax liability attaches to ownership. See Poe v. Seaborn, supra; Hoeper v. Tax Commissioner, 284 U. S. 206." *Blair v. Commis-*

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not use or dispose of the 1/4th of the oil going to Branson and Hammonds.

[14] This is the basis of this Court's decision in the Community Property Cases. See *Poe v. Seaborn*, 282 U. S. 101; *Hopkins v. Bacon*, 282 U. S. 122. In these cases the wife's share of community income was held to belong to her, regardless of the large measure of control which the husband exercised over this income in the ordinary case.

[15] This Court said in *Home Savings Bank v. Des Moines*, 205 U. S. 503, that all taxes are usually, if not necessarily, based upon the property of the person taxed—not upon the property of someone else. In *Knowlton v. Moore*, 178 U. S. 41, it was pointed out that a tax measured by the property of someone else would be of doubtful validity, and would probably "transcend those fundamental limitations" implicit in the Constitution. In the later cases of *Hoeper v. Tax Commissioner*, 284 U. S. 206, and *Nichols v. Coolidge*, 274 U. S. 531, Taxing Statutes were held invalid for this very reason. The Fifth Circuit said, in *United States v. Looney*, 29 Fed. (2d) 885: "But rents or royalties are not properly included in the income of one who did not own, receive or control them; the ownership thereof being vested in another when they accrued."

sioner, ... U. S. ....., 57 Sup. Ct. Rep. 330, No. 247, 1936 Term.

We believe this rule governs here and requires an affirmance of the Circuit Court's decision.

II

The question here presented was necessarily decided in accordance with the view of the Court below by *Palmer v. Bender*, 287 U. S. 551, and by *Fleming v. Commissioner*, 82 Fed. (2d) 324, *Commissioner v. Elliott Petroleum Company*, 82 Fed. (2d) 193, and similar cases, even though the right to depletion allowances was the primary question involved in those cases.[16] In the *Palmer* case, "discovery" depletion under the Revenue Act of 1921 was involved. This Act limited the depletion allowance to "net income from the property."[17]

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[16] *Commissioner v. Jones*, 82 Fed. (2d) 329; *Commissioner v. Williams*, 82 Fed. (2d) 328, both decided by the Fifth Circuit with *Fleming v. Commissioner; Alexander v. Continental Petroleum Company*, 63 Fed. (2d) 927.

[17] The Revenue Act of 1921 contained the following provision regarding depletion: "Sec. 214(a) That in computing net income there shall be allowed as deductions: * * * * (10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that

This means, of course, the taxpayer's net income from the property. Since this Court held that Palmer was entitled to a very substantial amount of "discovery" depletion, it was necessarily held that he had at least an equivalent amount of net income "from the property." Otherwise, regardless of the nature of his interest in the property, no allowance could have been awarded. But in that case the Government contended that the assignments in question divested Palmer of all interest in the property and its oil reserves;[18] while Palmer contended

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date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter; *And provided further, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made*, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

[18] This Court stated that the assignment to the Ohio Oil Company made by the partnership, of which Palmer was a member, contained the following language: "* * * does sell, assign, set over, transfer and deliver * * * unto the Ohio Oil Company" the leased premises,

that, under Louisiana law, the instruments were subleases. This Court refused to pass upon or to be controlled by these views, or by the terminology which a State Court might apply. Instead, it was pointed out that Palmer continued to have "legal control" over a share of the oil, "a right to share in the oil produced," he, therefore, had an "economic interest" in the oil; his income was "derived from the extraction of oil" which constituted, in the ground, a common "reservoir" to which he, his assignees and the landowner must look for a return of their capital; the loss or destruction of this reservoir would be suffered jointly by Palmer and all concerned; he, therefore, was entitled to depletion to offset against the income he derived from the transaction.

After this decision, the Fifth Circuit, which had theretofore followed the view urged by the Government in the *Palmer* case, refused again to hold that, under instruments like that here involved, the assignor had divested himself of all interest in the property.[19] In-

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and provided as the consideration a "present payment of a cash bonus, a future payment to be made 'out of one-half of the first oil produced and saved' to the extent of $1,000,000.00, and an additional 'excess royalty' of all of the oil produced and saved." The Court also stated that the other assignment involved, in favor of Gulf Refining Company, was a similar document. Thus the granting language was at least as broad as that contained in the assignment to Perkins.

[19] The earlier cases by the Fifth Circuit are briefly referred to at page 51 hereof, and it is there shown that it has been generally recognized that these decisions were overruled by this Court's decision in the *Palmer* case.

stead, in cases involving the right of the holder of oil payments, indistinguishable from those outstanding against Perkins' property, to percentage depletion, (which right the Government contested upon the theory that the assignor holding the oil payment had divested himself of all interest in the property) that Court held that what such an assignor really sold was the leasehold and the right to all of the oil, except that necessary to satisfy the oil payment, which latter amount was not sold.[20] Therefore, the Fifth Circuit held such an as-

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[20] The language involved in the *Fleming* case is almost identical with that contained in the assignment to Perkins. The contract provided that the lessee owners contracted to sell and convey, by proper assignment, and transfer all their entire interest in and to oil and gas lease and all oil, gas and other minerals produced therefrom. The consideration provided for was $1,000,000.00 in cash "and $1,000,000.00 out of one-fourth of all oil, gas and other minerals produced from said working interest in said lease, being one-half of the interest hereby conveyed; said $1,000,000.00 is not and never shall be a personal obligation or liability against the second party, but shall be paid only out of the products if, as and when produced and sold from the said premises." The Court said as to the Commissioner's contention: "In this case, the Commissioner contends that in the sale of each lease the whole amount paid, whether in cash or from production and sale of oil, was purchase money and subject to no depletion, pointing to *Pugh v. Commissioner*, 49 Fed. (2d) 76." The Court said: * * * * the payments from oil were not the independent capital of the of the purchaser, but represent a part of the oil reserve. The purchaser was not bound personally for these payments. If the oil ran short or proved non-existent, the taxpayer

signor-oil payment holder was entitled to percentage depletion on the amount received to apply upon the oil payment, he receiving to that extent income from the property, in which, on that account, he had an economic interest; that is, a right to share in the oil produced.[20A]

A recognized authority of Federal Taxation states: "Where the income is, there the depletion should be also."[21] In other words, the one taxed upon income de-

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was a proportional loser. *While the contract was phrased as though the lease and all the oil were sold, and as though the proceeds were to be paid back to the seller, the real essence of the transaction was that the lease was sold and all the oil except that whose proceeds were to come to the selling taxpayer.* The conveyance executed when the cash was paid might very appropriately have *reserved* or *excepted* sufficient oil from that thereafter run to pay the agreed sum. * * * But it was in effect an exception or reservation of oil. *The thing sold for the cash consideration was the lease and all the oil except that so reserved.*"

The language of the conveyances in the other cases heretofore cited, involving the same question, is equally broad.

[20A] Depletion has never been, and cannot be allowed to anyone whose relation to the producing property is that of a creditor. While, in a sense, a creditor may have an economic interest in the oil property which secures the obligation due him, legally he can enforce his rights otherwise than from the property. The creditor, likewise, can discharge his obligation in cash. Here, Perkins could not require Branson and Hammond to do any thing except accept their share of the oil as produced.

[21] *Paul & Mertens' Law of Federal Income Taxation*, Vol. 2, Para. 21.18, 1936 Pocket Supplement. At

rived from the extraction of oil or gas, is entitled to the depletion allowance. Thus the correct determination of the taxpayer entitled to the depletion allowance necessarily involves the prior determination of the taxpayer who must report the income.

The Government suggested in its Petition for Certiorari (p. 6) in this case that this was not true, that a different rule might be applied in awarding depletion allowances than in determining who reports income. This is a complete reversal of position, we submit. In all of the cases prior to this Court's decision in the *Palmer* case, and in that case, the Government contended that assignors, like Branson and Hammonds, were not entitled to depletion because they had parted with all of their title to the property, they did not receive income from the extraction of oil or gas, but the amounts which they received were a part of the consideration for the outright sale of the property. This was in accordance with the position which the Bureau of Internal Revenue has taken from the beginning as to the connection between income and depletion. Heretofore it has not been disputed that the "owner" of income derived from the extraction of oil or gas was entitled to a depletion allowance; the controversy has been as to whether the claimant of the allowance was such an owner. The Regulations have consistently announced

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this paragraph, pages 204 et seq. there is a splendid treatment of the whole subject, and when this is compared with the treatment in the original text, at Vol. 2, Para. 21.18, Pages 702, et seq., the development of the subject in the last two or three years is clearly shown.

this principle. In *Regulations* 45 (1918 Act) it was said, as to the statutory depletion provisions:

> "The essence of this provision of the statute is that the *owner* of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depreciation and depletion deductions the return of" capital. (Art. 201).

And in *Regulations* 94, promulgated under the Revenue Act of 1936, the same thought is thus expressed:

> "Under these provisions of the Act the *owner* of an interest in mineral deposit, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions, etc." Art. 23(m).

It is now too late, we say, for the Government to repudiate the connection between income and depletion, particularly since the statutory provision granting the allowance has been continued in practically the same language from 1918 down through the Revenue Act of 1936.[22]

Apart from the force of this continuous interpretation, no other conclusion could be reached under the Act. The pertinent section says that:

> "In case of oil and gas the allowance for depletion shall be 27½ per centum of the gross income

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[22] In *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, this Court gives a comprehensive resume of all of the statutory provisions regarding depletion.

from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.* Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Sec. 114 (b) (3).

In the *Twin Bell Oil Syndicate case.* 293 U. S. 312, the taxpayer contended, in effect, that "the gross income from the property meant 100% thereof, regardless of to whom the income belonged, and that it was therefore entitled to base its allowance upon the royalties and overriding royalties going to others, as well as upon the share which it kept, this right being limited only by the phrase "50 per centum of the net income *of the taxpayer* * * * * from the property." This case arose under the 1926 Act. The statutory provision was identical with that above quoted, except that it did not contain the italicized phrase as to excluding from gross income rents or royalties paid or incurred by the taxpayer. This Court held that the italicized addition to the section, first inserted in the 1932 Law with which we are here concerned, was merely declaratory of existing practices. The taxpayer's claim was denied because the phrase "gross income from the property" was not synonomous with gross income as defined in Section 213, "property did not refer to the tract of land in all of its uses," but to "gross income from oil and gas," the "retained oil" in the case of the operator be-

ing his basis for depletion, and the royalty oil being the basis for the depletion allowance to the royalty and overriding royalty owner. Thus this Court held, we say, that the percentage depletion allowance must be based upon the taxpayer's gross income from oil and gas, not the income of some one else from that source.

So, here, if the various Circuits and the Board of Tax Appeals are correct in holding that all those similarly situated to Branson and Hammonds are entitled to percentage depletion allowances, then it was necessarily decided that they, and not those situated as Perkins is, received "gross income from oil" to the extent of the oil or its proceeds going to them.

This Court was influenced in reaching its decision in the *Twin Bell* case by the fact that, if the taxpayer's position was sound, the total allowances would be based upon more than 100 per centum of the gross income from the property because the royalty and overriding royalty owners must be awarded depletion on the amounts received by them. We have exactly that situation here. The Government has based Perkins' depletion allowance upon that oil which went to Branson and Hammonds, as well as the oil which he retained. (We did not claim this additional allowance, and admit it was incorrectly allowed). But Branson and Hammonds are entitled to an allowance upon their one-fourth, as, of course, is the ordinary royalty owner. This results, as is expressly forbidden by the *Twin Bell* decision, in aggregate allowances based upon 125 per centum of gross income from the property from oil and gas.

That each one interested in an oil property must base his allowance upon "his" gross income from the property was expressly held on March 29, 1937, by the Tenth Circuit Court in *Crews v. Commissioner*, (official citation not available). There the proceeds from oil, which had been impounded during litigation over the property, were lost through embezzlement by the custodian of the impounded fund. The successful litigant claimed that his depletion allowance should be based as well upon the amount lost by this embezzlement as upon the amount actually received and impounded as income. The Court denied this contention saying, in part:

> "It is true that the first sentence of section 114(b)(3) uses the phrase 'gross income from the property' but we think the phrase 'to the taxpayer' is necessarily implied."

This is precisely the construction for which we contend, and it is precisely the construction very recently sought by the Government in the *Crews* case,

Darby-Lynde Company v. Alexander, 51 Fed. (2d) 56, is typical of another line of cases which are pertinent here. After the percentage method of calculating depletion allowances was adopted (1926 Law), many taxpayers contended that the allowance should be based upon any gross income derived from any use or disposition of the property as, for example, an outright sale, and should not be limited to gross income derived from the extraction of oil or gas. This contention was denied, and the meaning of the phrase restricted, as this Court

later did in the *Twin Bell* case, to income derived from the extraction of oil or gas. In these cases it was not contended that depletion could be based, as to any taxpayer, upon something which was not a part of that taxpayer's gross income under Section 23. Instead, the controversy was as to how large a part of "gross income" under Section 23, could be considered as "from the property" for the purpose of fixing the depletion allowance. Similar cases are *South Vernon Oil Company v. Hopkins*, 49 Fed. (2d) 1028. *Fritz v. Commissioner*, 76 Fed. (2d) 460, affirming 29 B. T. A. 408.

We submit that all of the difficulties which the Government appears to have with tax problems, relating to oil and gas, will disappear if the Government will recognize the true nature of the developments and operations carried on under an oil and gas lease. In all of those cases, except the rare ones in which oil lands are developed and operated by a fee owner, the operation is truly a joint venture. One person has the land, but is usually without the capital or the experience, or both, necessary to realize upon it. He lets the land on shares, —sometimes receiving a cash bonus, the size of which will depend upon the brightness of the prospect of securing oil on the land, but always he shares in profits. No matter how many times this operation is repeated—by assignment, sublease, overriding royalty, oil payment or any other similar arrangement —the co-operative and joint nature of the project remains. This is true in every case, except where there is a personal fixed obligation,—a note, a debt, or some thing of that sort—given as the only consideration for

a transfer. No matter into how many portions the 100% of the oil may be divided, as long as it constitutes a common reservoir from which all parties concerned must look for a return of their capital and for their profit, so long as each one has the sole right to benefit by or dispose of a specified fraction of the oil, that one derives income from the oil as produced. He has an economic interest therein,—that is, a right to a share of the oil produced. He reports that share as a part of his gross income and, under the express wording of the Statute granting him a depletion allowance based upon this gross income from the property, he is entitled to depletion based upon the amount so accounted for as income from that property.

From this it necessarily follows that if one reports income, he is awarded depletion, and, if he is awarded depletion, it means that he has gross income from the property.

III

Certiorari was granted in this case upon the assertion that the decision below conflicted with that of the Eighth Circuit in the *Comar Oil Company* case. Apparently, such a conflict exists.

There are differences in the fact situation which will be referred to hereafter, but we will say at once that we believe it can be fairly demonstrated that the Comar decision is unsound; that it is based upon a misconception of well established Departmental tax practices, upon a misconstruction of the Statutes involved

and a misapplication of the authorities cited to support the conclusion reached.

Although *Palmer v. Bender*, supra, by this Court, was cited in the opinion, its significance was not, we respectfully say, appreciated. In their briefs both parties refer to the Circuit Court's decision in the *Palmer* case, but all briefs, except that contained in the Petitioner's Motion for Rehearing, were prepared before this Court's decision in the *Palmer* case, and that decision was no where discussed by either party.

The facts hereinafter pointed out are based more upon an examination of the Record in the Eighth Circuit, than upon statements in the opinion. There were three different transactions involved. One was with Goldelline Oil Corporation, one with Henry Rosenthal and one with Alcorn Oil Company. That with Goldelline Oil Corporation comes nearer paralleling the one here involved than the others, and it will be first referred to.

The assignment made to Comar Oil Company by the aforesaid corporation recited a consideration of $50,000.00 "and the additional sum of $100,000.00 net to be paid out of the oil and gas as hereinafter set out." It purported to assign all of the assignor's right, title and interest. It was further provided:

> "The above mentioned sum of $100,000.00 net shall be paid to the assignors herein out of one-eighth of the gross production of oil and gas produced from said property, by the assignee or its assigns, and said assignors shall not be liable, and their one-eighth of the oil and gas shall not be

chargeable with any cost and expense of developing, operating and marketing said oil and gas or any cost whatsoever. Statements of production and payments thereunder shall be made by assignee each month to Goldelline Oil Corporation and Errett R. Newby until each shall have received the sum of $50,000.00 out of the said one-eighth of the gross production. It is understood that a lien is hereby retained by first parties on said one-eighth of the oil and gas until said sum of $100,000.00 is paid."

Thus this instrument did not expressly negative personal liability upon the part of Comar Oil Company for the additional $100,000.00. It was not provided that said sum should be paid "only" out of oil. The quoted excerpt, with other testimony, show clearly that Comar did not deliver oil in kind, but sold all of the oil and accounted for proceeds. The inference that a creditor-debtor relation existed was re-enforced by the provision for a lien.[23] The obligation which would usually be implied in such an instrument to develop reasonably, or to stand the consequences, was not negatived. This, we say, is the instrument which more closely parallels the assignment to Perkins than any other involved (R. 44 Comar case).

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[23] The Board of Tax Appeals, in the *Fleming* case, 31 B. T. A. 623, considered the *Comar* case and distinguished it in the following language (Page 627): "There it appears that the assignee and his assigns were liable for the deferred payment, and the assignor had a lien on one-eighth of the oil produced from the property until the amount of the deferred consideration was paid."

The Rosenthal assignment contained no provision whatsoever for an oil payment. It recited a consideration of One Dollar and other good and valuable considerations, and purported to assign all rights to the lease and to warrant the same (R. 50 Comar Case). The provision for the oil payment was contained in the preliminary contract of purchase, and nothing in the Record indicates that it ever went of record or otherwise qualified the apparently absolute title acquired by Comar. This contract provides:

> "That the first party hereto has this day bargained, sold and assigned and transferred to second party hereto all of his interest in the said oil and gas lease upon said lands hereinabove described, same being an undivided one-fourth interest, for the consideration of One Hundred Thousand Dollars cash, and Fifty Thousand Dollars to be paid to the party of the first part by party of the second part out of one-half of their portion of the first oil or gas produced, same to be made when and as the oil is sold." (R. 49 Comar Case).

The same situation existed as to the largest transaction,—that with the Alcorn Oil Company. The provision regarding payment, was contained in the preliminary purchase contract (R. 54 Comar Case), and not in the assignment placed of record (R. 57, Comar Case), which assignment merely recited one dollar consideration paid, and conveyed with a warranty of title all of the Alcorn Oil Company's interest in the lease.

The purchase contract referred to bound the Comar

to pay Three Million ($3,000,000.00) Dollars; $1,750,000.00 upon approval of title:

> "• • • the balance, amounting to One Million Two Hundred Fifty Thousand Dollars ($1,250,000.00) shall be paid by Comar out of fifty per cent (50%) of the oil produced as represented by the working interest in said properties. The title to all of the working interest in the oil produced from said properties subsequent to the date of this agreement shall be in Comar Oil Company, and as oil is produced Comar Oil Company shall pay to the Alcorn Oil Company sums of money equivalent to the value of fifty per cent (50%) of the oil produced, as aforesaid."

Under all of these instruments, no oil was delivered in kind, or intended to be, and the last instrument expressly provided that title to all oil passed to the Comar Oil Company the assignor to be paid amounts "equivalent" to the value of fifty per cent (50%) of the oil produced.

When the case reached the Circuit Court, that Court, in its consideration of the matter, divided the question into two parts. The first was whether it was proper to include the payments made to the three assignors in the income of Comar. The second was whether, if they were so included, they should not have been thereafter eliminated as allowable deductions.

In dealing with the first branch of the question, the Court first referred to the broad scope of the general definition of "gross income" in the Act and said, citing authorities, that this definition was broad enough

to include, in the case of a lessor, rents or royalties paid to him by the lessee. This, of course, is a sound statement, but the Court continued:

> "• • • broad enough to include, in the case of a lessee, rents or royalties *paid by him to the lessor owner;* and the practice has been to include them as gross income in the return."

If we may be permitted to assume that the Court meant exactly what it said in this quotation, then we say that there is disclosed a complete misconception of the situation. We say that rents paid by a lessee are not included by the lessee, who pays them, as a part of his gross income, and cannot be. The same is true of royalties paid by a lessee. If the Circuit Court's statement were correct, the more rent or the larger royalty a lessee paid, the more would be his gross income.

The cases cited by the Court to support this statement utterly fail to do so. Not one hints at such a conclusion. They are all briefly analyzed and discussed in the Appendix, infra page 71.

If what the Court intended to say was that the lessee's or tenant's receipts from which, in the ordinary case, he might expect to pay rents or out of which he would defray royalties constitute a part of his gross income, another situation is presented. Such a statement may or may not be accurate, depending upon the precise facts.[24]

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[24] Rents or royalties payable in cash need not be paid out of the gross income of the one making the payment. Of course the one obligated expects to derive

The Court then referred to the fact that the payments in question were called "overriding royalties" and that Comar contended that these overriding royalties should be treated in the same manner as the original royalties. The Court thought that this contention was sound:

> "• • • in so far as it results in the inclusion of both the original royalties and the overriding royalties in the catagory of 'gross income'."

The Court recognized the forcefulness of the argument that neither overriding royalties nor original royalties should be included in the gross income of a lessee, sublessee or transferee, but said that the argument should be addressed to Congress, because the inclusion of them in the gross income of the lessee found support in the definition of gross income in the Act and "in the actual practice established during a considerable number of years. See cases cited above." These cases cited are those which we have discussed in the Appendix. Thus it will be seen that the Court predicated this part

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gross income from his business operations sufficient to discharge his rents and royalties and yield a profit, but as a matter of fact they may be paid out of capital, out of borrowed money, out of the sale of assets which produced no profit or resulted in a loss, out of inherited or donated funds, or from many other sources. The recipient is ordinarily not concerned with the source of the money. If the royalties are payable in kind, as oil royalties customarily are, they do not, under the long established practice as shown by the Record in this case and under well settled principles, constitute a part of the lessee's gross income.

of its opinion upon the entirely mistaken hypothesis that in the case of original royalties the lessee was required to report these royalties as a part of his gross income. The cases cited by the Court to sustain its statement do not do so. The Government cannot point to any other cases which do so. We established the departmental practice by uncontradicted evidence and that practice is this: Royalties payable in kind are not included in the gross income of the lessee or operator. Where royalties are payable in cash, the lessee reports the proceeds from the sale of all minerals and takes an offsetting deduction for the royalties paid. The propriety of such a deduction was admitted in the brief below. There it was argued that the amount received by Branson and Hammonds constituted payment of a portion of the purchase price and it was said, on page 18 Collector's brief below.

> "There is no similarity between such a payment and that of an original royalty or rent, fixed in amount and time, which of course may be deducted as an expense."

Having concluded, by the line of reasoning above analyzed, that Comar was required to include the proceeds from the sale of all of the minerals as a part of its gross income, the Court next turned to whether or not Comar could deduct from this gross income the amounts paid over to its several assignors. Upon this point the Court said:

> "We think the statute makes plain distinction between rentals or other payments for the con-

tinued use or possession of property to which the taxpayer has not taken title or in which it has no equity on the one hand, and rentals or other payments for the continued use or possession of property to which the taxpayer has taken title or in which it has an equity on the other hand. The former rentals are deductible; the latter are not. What the reason for the distinction is, we are not called upon to decide."

It should be noticed that the Court had previously held that the payments in question were overriding royalties which should be treated as ordinary royalties. It was not decided, as the Government here contends, that these were payments to apply upon the purchase price. The quoted conclusion reached by the Eighth Circuit directly conflicts with the admission made in the brief below by the Government, which we have previously quoted. It conflicts with long-established practice upon the part of the Bureau of Internal Revenue, for all royalties and rents (except those payable in kind which are never dealt with at all in the payer's tax return) have always been deductible. The language of the Statute (set out in full below)[25] refers to an

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[25] *Revenue Act of* 1932. "Sec. 23. Deductions From Gross Income. In computing net income there shall be allowed as deductions: (a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . . and rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

entirely different type of transaction than those relating to mineral properties involved here. Those here involved were not made for the "continued use or possession of property to which the taxpayer has not taken title or in which it has no equity." In many States a lessee or his assigns cannot take title to oil in the ground. The general rule is that non-payment of royalties under an oil and gas lease does not work a forfeiture of the lease.[26] Use and possession for the purpose of prospecting for and producing the oil, or other minerals, are acquired for the down consideration or bonus (which the lessee paying same capitalizes and does not deduct),[27] and the royalties, payable in kind or measured by the quantities produced, represent the lessor's share of the profit from the mining operation which he realizes through the ancient device of leasing on a royalty basis.

It is interesting to note that upon this phase of its

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[26] *Thornton on "Oil and Gas"*, 5th Ed. (Willis), Vol. 2, p. 562, paragraph 304, and authorities there cited. Under these decisions the payment of the royalties is not a condition to the lessee, or any one holding under him, continuing to use or possess the property. If it were such a condition, a breach of the condition would work a forfeiture. This phase of oil and gas law, at least in so far as it applies to Texas, is fully discussed in *Waggoner Estate v. Sigler Oil Company*, 118 Tex. 517, 19 S. W. (2d) 27.

[27] This has always been the rule. The bonus, as to the lessee, is his cost, recoverable through depletion, when depletion is taken on the basis of cost. See *Art.* 203, *Regulations* 45, 1918, Act, and this has been carried through continuously to the present time. *Art.* 23 (m-6) *Regulations* 94, 1936 Act.

opinion, the Eighth Circuit cited no decisions whatsoever.

It was after that portion of the opinion which we last quoted that the Eighth Circuit referred to the *Palmer* case by this Court. It then said, after saying that they were not called upon to decide the reason for the distinction:

> "It may be that the Congress thought that in the latter class of cases, the depletion allowance provided in section 234(a) (9) could be made and would be sufficient. See Palmer v. Bender, 287 U. S. 551. Whatever the reason for it, the distinction, we think, exists."

Thus that Court indicated that the lessee or operator would be compensated for a refusal to allow it to deduct royalties paid by an allowance for depletion with respect to the oil applicable to the oil payments. But, under the *Palmer* case, under the *Fleming* case, and similar cases, that allowance would go to the assignor-oil payment holder, and, under this Court's decision in the *Twin Bell Oil Syndicate* case, the same amount could not be made the basis for the same or a corresponding allowance to the lessee operator. Indeed, as this Court pointed out in the *Twin Bell* case, the Statute with which we are here concerned expressly required all royalty payments made by a lessee to be deducted from gross income before computing percentage depletion, and this, as this Court pointed out, was not new; it was merely declaratory of long existing practices.

There is nothing in the *Comar* case which tends to

support the theory upon which the Government sought below, and here seeks, to sustain its position. That theory, and the one adopted by the Trial Court, was that the assignment conveyed title to all of the oil which formerly belonged to the assignor or lessee, and that the oil and money which went to Hammonds and Branson were payments upon the purchase price of this oil. We fail to see how the Government can find comfort or obtain support for any such theory by any thing said or inferred in the *Comar* decision. And, as above shown, the principles upon which that Court founded its decision are contrary to the Government's long continued practices, and some of the statements there made have been expressly repudiated by the Government in its argument below.

IV

The opinion of the Fifth Circuit in *Palmer v. Bender* was typical of a group of opinions delivered by that Circuit, within the space of a few years, in which the same principles were applied. Many of these cases involved the identical contracts which were involved in the *Palmer* case.

A typical case involving a different contract is *Pugh v. Commissioner*, 49 Fed. (2d) 76. As stated by the Fifth Circuit in the case at bar, the Trial Court appeared to prefer the reasoning of this opinion to the opinion delivered by the same Court in the *Fleming* case, *supra*. An analysis of that case will show that it was necessarily overruled by this Court's decision in the *Palmer* case. Pugh was a landowner who had leased his

lands, retaining the usual royalty. He later transferred this royalty. The assignment purported to transfer all of it, but the consideration expressed was partly cash, with the remainder from a specified percentage of the oil to be produced from the property. Pugh claimed depletion with respect to the amount received from the oil produced after his transfer. The Fifth Circuit held that this was a conveyance, as well of the amount of the oil necessary to satisfy the oil payment as of the remainder of the estate conveyed, and, because of that, denied the claim for depletion. Similar results were reached by the same Court, not only by its decision in the *Palmer* case, but in *Waller v. Commissioner*, 40 Fed. (2d) 892; *Herold v. Commissioner*, 42 Fed. (2d) 942; *Beene v. Commissioner*, 40 Fed. (2d) 892; *Baird v. Commissioner*, 65 Fed. (2d) 911.

It would appear that the Fifth Circuit expressly recognized the fact that this Court's decision in *Palmer v. Bender* overruled the Fifth Circuit's decision in the *Pugh* and similar cases, for it was there said:

> "We have thus looked at the transaction broadly, as was done in *Palmer v. Bender*, and not technically, as was done in the *Pugh* case."

And this recognition is made clearer by the opinion in the present case. The Court below said (R. 98):

> "In dealing with income taxes in connection with transactions in oil leases this court at first attempted to apply the peculiar law of Texas or Louisiana and the resulting technical relationships of the parties. Such decisions were made in Pugh

> v. Commissioner, 49 Fed. (2d) 76; Harmel v. Commissioner, 56 Fed. (2d) 153; and Palmer v. Bender, 57 Fed. (2d) 33. • • • • While the reasoning of the Pugh case may be correct upon a question of title to the oil and the ordinary consequences of title, we cannot regard it as a valid authority on the present question."

The Ninth Circuit, in *Commissioner v. Elliott Petroleum Company*, 82 Fed. (2d) 193, a case similar to the *Fleming* case, said:

> "Our conclusion is in accord with the decision of the Tenth Circuit Court of Appeals in Alexander v. Continental Petroleum Co., 63 Fed. (2d) 927, under the Revenue Act of 1926 and the above cited decisions of the Supreme Court. The case of Pugh v. Commissioner, 49 Fed. (2d) 76, cited by the Commissioner, it is agreed tends to support his contentions, but in so far as it conflicts with Palmer v. Bender, 287 U. S. 551, supra, it is no longer authority."

In the *C. C. H.* 1936 *Tax Service*, Volume 1, paragraph 204.143, page 834, there are listed a large number of decisions which are stated to be "no longer effective as precedents due to the holding of the Supreme Court in the *Palmer v. Bender* case." And *Paul and Mertens* in their *Law of Federal Income Taxation* say that these cases "have now in principle been reversed by a recent decision of the Supreme Court." See Paragraph 21.18, Volume 2, page 702. Both of these authorities cite all of the cases above listed.

We believe the Government must base its position here upon exactly the contention which it made in all

of these cases which we have referred to. That contention is that under the terms of the assignments involved the assignor parted with all his title to the oil and placed all of the title in the assignee, so that the assignee, situated as Perkins is here, should report the proceeds from the sale of the oil as his income, and so that he would be entitled to depletion with respect to all of it. This basic position which the Government must take has been expressly recognized by many authorities to have been overruled by this Court in *Palmer v. Bender*.

V

The following principles, though unrelated, are pertinent and require, we submit, an affirmance of the lower Court's decision.

(a) The Bureau of Internal Revenue would have accorded the tax treatment desired by Perkins, if the instrument had "reserved" one-fourth of the oil to Branson and Hammonds until they had received the specified sum; but contends that the treatment should be different because the assignment to Perkins assigned the entire lease (as was done in the *Palmer* and *Fleming* cases) and bound Perkins to pay or deliver one-fourth of the oil until the same sum was received. But there is not the slightest practical difference in the two situations. Perkins' gain under one is exactly what it would have been under the other. Such immaterial differences in phraseology should not be made the basis for very substantial differences in tax liability. We challenge the Government to point out any practical dif-

ference under the two types of instruments.[28]

(b) While the Bureau of Internal Revenue contends that the oil payment going to Branson and Hammonds is a part of the consideration paid by Perkins, it has refused to follow this principle to its logical conclusion in this case, and many others. If Branson and Hammonds conveyed all of their interest in the leases to Perkins in consideration of cash and an additional sum to be paid later, it would seem that this additional sum, even though contingent, would necessarily be a part of Perkins' original cost, in just the same way as if he had given notes for a deferred consideration. There might be a difference in the value of notes unconditionally enforceable and the value of an obligation contingently payable, but each, on some basis of value, would represent, under the Government's theory, a part of the original cost, and to be consistent the Government should treat this additional sum as a part of the cost, just as it would deferred payments. If this were done, Perkins would be allowed to base his cost depletion deduction upon this total cost, just as in the case of property bought on credit depletion or depreciation on cost would be based upon the purchase price, regardless of when paid.

Instead of following this theory, the Government treats as the basic cost, for cost depletion purposes, the

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[28] We have ventured to insert in the Appendix page 85 excerpts from an actual case now pending to illustrate the distinction which the Bureau of Internal Revenue is making at the present time because of the verbiage of the instrument.

consideration actually paid in money or notes at the date of the conveyance. To this, each year, is added the amount actually received by the oil payment holder, and thus for the next year the cost depletion basis is the original basis, plus this additional payment, so-called, and this process is repeated each year until the oil payment is extinguished. Thus as the property is depleted and as oil reserves go down, the taxpayer's cost for depletion purposes, under this theory of the Government, goes up, increasing each year the depletion unit. But the logical result of production and extraction is to retire cost and to reduce depletion charges ratably. Let us illustrate this result, using an extreme but not impossible case for the sake of brevity.

Assume an assignment for $10,000.00 in cash and $90,000.00 payable out of 6/8ths of the oil (1/8th, as in the customary case, going to the landowner as royalty and the other 1/8th being "free" for the operator). Assume a 200,000 barrel reserve and a price of oil of $1.00. During the first year the operators produces 100,000 barrels and completely retires the oil payment. During that year his cost is $10,000.00, his reserves 200,000 barrels and his depletion allowance five cents per barrel. The next year his cost would be $10,000.00, plus the amount of the oil payment—$90,000.00, less the $5,000.00 depletion allowed in the previous year; his reserves would be only 100,000 barrels and his depletion unit, ninety-five cents per barrel.

It should also be recognized that in this case if production should suddenly terminate early in the second

year, the operator under the Government's theory would have a loss deduction of $95,000.00.

These entirely fanciful and impractical results arise from the falure of the Bureau of Internal Revenue to recognize the practical fact that the operator in such a case did not acquire all of the oil—that, instead, he was merely producing on shares.

(c) We desire to emphasize that the testimony in this case shows it to be the established practice of Oil Purchasing Companies, (and indeed Courts would probably take judicial notice of the fact without such testimony), to require the execution of division orders, like those shown in the record in this case, by all interested in an oil well before the oil purchaser will run and pay for the oil. The division orders in this case show that Branson and Hammonds on the one hand, and Perkins on the other, recognized that they jointly owned the working interest; that Branson and Hammonds had one-fourth thereof and Perkins three-fourths. They refer to themselves in such division orders as the "owners" of these respective fractions. The Purchasing Companies so recognized and treated them. No Purchasing Company would have paid Perkins for Branson and Hammonds' one-fourth of the oil. All of these facts and customs must be read into the assignment from Branson and Hammonds to Perkins, for they certainly contracted in the light of established trade practices and customs. These customs should be considered in connection with the language of the instrument to the effect that the oil was to be delivered by Perkins to Pipe Line Companies for the account of Branson and Hammonds, who were

to be paid directly for the same by the Pipe Line Companies.

These facts not only show the practical aspects of the situation; but they show convincingly the way the parties interpreted their own contract.

VI

The Trial Court appeared to be concerned over the economic consequences of a holding to the effect that Perkins should not include as a part of his income the proceeds from the oil going to Branson and Hammonds (R. 19), and the Government's Petition for Certiorari in this case suggests that it shares in such concern. It is clear, however, that there is no actual basis for such concern; rather, we say, the oil industry should be concerned over the present attempt to impose double taxation upon it.

The Trial Court spoke of the enormous amount of money which would "be swept aside as income" if the contention advanced by Perkins should be upheld. This is a mistaken conception. As we have heretofore pointed out, all of the money or income produced from an oil well will be taxed as gross income to those actually benefited thereby if our theory of the case is upheld. The royalty owner will report his share; Branson and Hammonds will report their share and Perkins will report his share. But we will admit that neither of these parties will be taxed but once upon the same income, while, if the Government's theory is adopted, two people will be simultaneously taxed upon the same income.

Take this very case as an example. We may safely

infer from the date of the original leases and because none of them had been developed by Branson and Hammonds at the date of their transfer to Perkins, that Branson and Hammonds' investment in the leases was very much less than the $155,000.00 received in cash and notes from Perkins, and this much of the transaction with Perkins resulted in a substantial profit to them. This profit should have been, and no doubt was taxed to them,—that is the difference between their cost and $155,000.00. Now, if the additional amounts which they receive are taxed to them as a part of the consideration, they will report as income one-fourth of the amount produced by the oil wells in question, although this one-fourth is simultaneously included as a part of Perkins' gross income. This, clearly, is double taxation.

To this the Government may say that the same result would be reached if Perkins had given an unconditional obligation of $395,000.00, but had actually retired this obligation out of the proceeds from the sale of one-fourth of the oil. But this is not correct. In such a case, this $395,000.00 would have been treated by the Government as cost and Perkins would have immediately been permitted to deduct cost depletion based on that amount. Under the Government's practice this right is denied him and the depletion deduction deferred to be realized, if at all, long after he has been compelled to combine that which is actually the income of Branson and Hammonds with his own income and pay taxes upon the total at progressive rates, thus burdening him, not only with taxes upon some one else's income, but with higher rates upon his own income.

We respectfully say that the economic consequences which might result if the Government is permitted so to tax business interests is to ruin and destroy those interests. The Government should be satisfied to tax income only once. With rates as high as they are now, it is entirely possible for an oil producer, operating under a plan like that here involved, to be taxed at more than 100% of what he is permitted to keep "for his separate use, benefit and enjoyment."

VII

The Government's brief in this case was only received shortly before Respondents' brief was completed. In concluding we will refer directly to some of the arguments there advanced.

In the opening sentence of the Petitioner's Summary of Argument it is said "Taxpayer and associates operated oil wells and sold the oil." Under this Record we say it is clear that Respondent did not sell the one-fourth of the oil going to Branson and Hammonds. They could not sell the same under the terms of their assignment and under clearly established and well-known trade practices and customs, and they made no attempt to do so. Instead, they delivered one-fourth of the oil into the Pipe lines serving the property to the credit of Branson and Hammonds and Branson and Hammonds executed each and every instrument by which the oil was sold and collected directly therefor in accordance with the terms of these instruments from the purchasers of the oil.

Petitioner next says: "The proceeds of all of the

sales of oil made by them constituted income from their business." This is incorrect, we say, because so much of the proceeds as went to Branson and Hammonds were never, and never could have been, received by Respondents for their own benefit, or for their separate use and disposal. If they had appropriated this oil, they could have been held for conversion, in just the same way as if they had appropriated the royalty owner's one-eighth.

The Petitioner then proceeds to assert that Perkins acquired complete title to the lease and to the oil in place. We have already replied sufficiently to this, except in so far as the Petitioner predicates its assertion upon the case of *Holliday v. Erwin*, 85 S. W. (2d) 355. This is a decision by one of eleven Courts of Civil Appeals of Texas,—intermediate courts. That Court attempted to make a distinction because the assignment provided for a payment "out of 1/4th of the 7/8ths of the first oil," instead of a provision that the assignor was to "receive 7/8ths of the first oil produced," and because it did not contain an express provision that title was to remain in Erwin until he was paid.

Apart from this, an examination of the entire opinion, including the opinion delivered on Motion for Rehearing, will show that the Court's decision was predicated, primarily, upon whether or not the particular action, which was to cancel a receipt given acknowledging satisfaction of the oil payment, could be maintained on non-resident service.

Most important, in connection with this case, is the fact that on October 9, 1935, the Supreme Court of

Texas granted a writ of error in this case. The notation made by the Court in granting this writ of error was in the following language:

> "Granted on first assignment."

This assignment was that:

> "The Court of Civil Appeals erred in holding that, under the terms of the assignment from appellee of the oil and gas lease, he conveyed all his rights in the lease and thereby, in effect, holding that appellee, under the facts pleaded and proven, did not show himself to have any interest in the land and, therefore, his action was not one to establish such an interest." See The Texas Syllabi, Vol. 12, No. 2, issued under date of October 9, 1935.

At the date this brief is written, this case had not been submitted to the Supreme Court of Texas, and will probably not be heard by that Court before late in 1937. We say that it is much too early for the Petitioner to assume that the Supreme Court of Texas will qualify, in *Holliday v. Erwin*, supra, the long considered doctrine which it announced in *Sheffield v. Hogg*, supra.

The Petitioner then says, in his Summary of Argument:

> "Since the capital and labor entering into the production of the income here in question was owned and furnished entirely by the taxpayers, etc."

The Fifth Circuit, in construing a very similar in-

strument, reached exactly the opposite conclusion. In the *Fleming* case, supra, that Court said:

> "Contrariwise, the payments from oil were not the independent capital of the purchaser, but represented a part of the oil reserved."

The concluding sentence in the Summary of Argument is: "The taxpayers recover back their capital outlay through an allowance for depletion." This would seem to be an admission that the amounts received by Branson and Hammonds were not royalties or rentals. If they were, then under the Statute, even if we assume that the proceeds from all of the oil should have been reported by Perkins, his depletion allowance could not be based upon these rents and royalties because of the provisions in *Section* 114(b)(3) of the Revenue Act of 1932, excluding from gross income before computing percentage depletion:

> "An amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

This has been heretofore discussed, but we point out again that if these payments were a part of the purchase price of the leases, then all of the Courts who have granted depletion allowances to those similarly situated to Branson and Hammonds have done so in direct conflict with the well established rule that no depletion is allowable to the seller of an oil property with respect to the consideration received by him from the sale of the property.

Petitioner cites *Poe v. Seaborn*, 282 U. S. 101, one of the Community Property Tax Cases, in support of his assertion that the answer to the question of ownership must be found in the law of the State. We believe that this standard is very favorable to Respondent's view, and that the question of ownership under State law has been settled by *Sheffield v. Hogg*, supra, but in view of *Lynch v. Alworth Stephens Company; Palmer v. Bender* and *Burnet v. Harmel*, all by this Court, we seriously question whether the State law furnishes a complete answer to the question; but we submit, as heretofore pointed out, that any test which can properly be adopted will result in sustaining Respondents' position.

The Petitioner says:

> "If we find that under State law a particular taxpayer owns the capital which enters into the production of particular income and also performs the labor entailed in its production, it follows that that taxpayer is taxable under the Federal revenue laws upon that income."

And, after quoting from *Stratton's Independence v. Howbert*, 231 U. S. 399, it is said:

> "It would seem to follow that those who conduct that business (mining) are the ones to be taxed with its profits."

We ask the Petitioner to apply this theory to the ordinary royalty owner. If he says that under State law the ordinary royalty owner owns a share of the capital, then we ask him to point out why the lessee

upon assignment, by using language similar to that contained in the original lease, upon which the lessor's rights are predicated, cannot also continue to own a share of the capital—the oil in the ground? We do not believe that the one who conducts a business is necessarily to be taxed with all of its profits. We had always thought that the ancient landlord and tenant relation, particularly where land is let for a share of the crop, was a well known example of one conducting a business without being taxed upon all of the profits which resulted therefrom.

We will not extend this argument by discussing those decisions of Texas Intermediate Appellate Courts decided prior to *Sheffield v. Hogg*, which are cited by Petitioner. Whatever might have been said in them (and everything has been said in every way, as any one who examines all of the available decisions will find) is immaterial in view of the later and controlling opinion by the highest State Court.

The Petitioner refers to *Group No. 1 Oil Company v. Bass*, 283 U. S. 279, and to the fact that this Court in that case cited *Theisen v. Robertson*, 117 Tex. 489. An examination of *Sheffield v. Hogg*, supra, will show that the Supreme Court of Texas has repudiated the doctrine that the lessee acquired all of the oil and gas.

It should be noted that the Petitioner makes no serious attempt to sustain the reasoning in the *Comar Oil Company* case, upon which he predicated his Petition for Certiorari in this case. He avoids the depletion question and disregards the necessary connection

between income and depletion. He assumes that rents and royalties, in so far as they refer to an ordinary oil and gas lease, are paid for the continued use, possession or enjoyment of property in which the taxpayer paying them has an equity and are, therefore, not deductible; although, since we have had income taxation the Bureau of Internal Revenue has recognized—first, that royalties payable in kind are not to be accounted for in the gross income of a lessee; and, second, if they are payable in cash, they constitute a deductible allowance from the income of the lessee for the year with respect to which they are paid.

We submit that the issues would be clarified and the solution of the important tax problem now before the Court made easier if the Petitioner would frankly deal with the well settled practices of the Bureau of Internal Revenue in regard to the taxation of ordinary royalties, and if he would recognize the necessary relation between our present problem and the closely related problem of depletion.

We say that it is clear that Perkins derived no income on account of the one-fourth of the oil going to Branson and Hammonds, and that, not only is this controlling, but, unless the Petitioner can deny:

(a) That Branson and Hammonds are entitled to depletion upon the amounts received by them to apply on the oil payment;

(b) That if the said amounts were received as a part of the consideration for the sale of property, Bran-

son and Hammonds would not be entitled to depletion thereon;

(c) That if the Trial Court was correct in holding that Perkins bought all of the interest of Branson and Hammonds in the property, the proceeds from the sale of the oil subsequently produced was the gross income of Perkins "from the property" so that his depletion allowance must be based upon all of the same;

(d) That percentage depletion cannot be based upon more than 100% of the gross income from the property;

(e) That the amounts going to Branson and Hammonds cannot at the same time be "rents and royalties" and consideration received by them for the sale of the property;

The Petitioner should not prevail in this Court.

Respectfully submitted,

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APPENDIX A

TAXING STATUTES INVOLVED.
THE REVENUE ACT OF 1932

"SEC. 21. NET INCOME.

"'Net income' means the gross income computed under section 22, less the deductions allowed by section 23.

"SEC. 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. • • • •

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expend-

ed for meals and lodging) while away from home in the pursuit of trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

• • • •

"(1) DEPLETION.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For

percentage depletion, see section 114(b) (3) and (4).)"

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION. * * * * *

"(b) BASIS FOR DEPLETION.— * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

APPENDIX B

Analysis of the cases cited by the Eighth Circuit Court in the Comar Oil Company case to support the assertion made in the opinion in that case that rents and royalties paid by the lessee should be included in the gross income of the lessee paying the royalties or rents and that the practice had been to include the rents and royalties so paid in the gross income of the lessee.

United States v. Boston and Providence Railroad Corporation, 37 Fed. (2d) 670, First C. C. A., decided January 23, 1930:

The basic question involved in this case was a determination of the invested capital of the railroad corporation in order that its excess profits tax for the year 1918 could be properly determined. This company was a lessor and not a lessee. Before 1890 it had executed a ninety-nine year lease on its railroad properties for a cash payment of $1,300,000.00, annual payments of $400,000.00, a sum sufficient to keep the corporate organization alive, and certain covenants as to maintaining the property, paying taxes, etc. In addition thereto, the lessee had covenanted to pay off at maturity the funded and floating debt of the lessor railroad corporation and to create a sinking fund for the purpose.

The determination of invested capital turned upon the question of whether or not any part of the value of this contract to pay the debt of the lessor and to

establish a sinking fund for that purpose could be included in the invested capital of the lessor under the Revenue Act of 1918.

The railroad company of course contended that it could be. The First Circuit Court seemed to think that the question should be answered by determining whether or not, if the taxing statute had been in force when the lease was made, all or any portion of the value of this contractual obligation would have been treated as taxable income to the lessor. The Court said:

> "An amount paid in advance as rental, or as a bonus for a leasehold interest, may be prorated by the lessee in computing his income tax over the period of the term, upon the ground that the interest acquired is an exhaustible capital asset • • • or is a part of the rental; but, as to the lessor, in computing his tax it is treated as income in the year in which it is received. • • • While the case is not entirely free from doubt, we think the obligation to discharge the funded debt of the petitioner in this case was properly treated by the court below as income received when the lease was signed, at least to an amount equal to the fair cash value of the obligation."

Here, of course, the Court was dealing with the lessor. The lease did not involve a wasting asset like oil in the ground, and the Court expressly recognized that even such a lump sum payment as it was considering could be deducted over the life of the lease. If such a situation can be compared with a transaction relating to oil and gas, it is much more comparable to the bonus

or advance royalty paid by a lessee upon the execution of a lease. As to such a payment, the long established custom has been to treat the amount received as income to the lessor, subject to depletion, and as cost of the leasehold to the lessee who paid the bonus, but recoverable through amortization or other deduction over the life of the lease. In the case at bar we are concerned of course with payments comparable to the ordinary royalties paid under an oil and gas lease, which, as frequently stated in other portions of this brief, if payable in kind, never are included in the gross income of the lessee; and if payable in cash, are always deductible by the taxpayer.

The second case cited is *International Textbook Company v. United States*, 44 Fed. (2d) 254, decided by the Court of Claims on November 3, 1930. In that case one of the affiliated corporations which formed the group of corporations which were plaintiffs has acquired, in consideration of an advance of money and an agreement to pay a percentage of the gross receipts derived from selling the books, the exclusive right to sell certain domestic science courses. The tax year involved was 1918. The taxpayer sought to deduct in 1918 a portion of the cash payment made in 1916 when the contract above referred to was entered into. The Court of Claims denied this contention, pointing out that this cash payment was in no way dependent upon the amount the taxpayer was to receive from the sale of the course and that:

> "The whole amount was a fixed obligation from the time the contract was signed. It was an

obligation arising at the time the contract was made and was a payment for property rights of an income-producing nature available to the plaintiff from that time forward as long as the courses were desired."

In response to the argument that the taxpayer was entitled to a deduction for the exhaustion of these contract rights, it was pointed out that the rights were of an indefinite duration and there was no basis for a computation of exhaustion under the statute.

So this case merely holds that if one acquire for a down payment the exclusive rights, unlimited as to time, to market a literary product, the amount of the down payment can not be deducted from income in a later year and no part of it is deductible because of exhaustion of the rights, for the reason that the rights are of an indefinite duration and there is no basis for computing the exhaustion.

If we were to compare the situation to an oil and gas transaction, it might be considered the equivalent of a transfer for a cash consideration of the exclusive right to mine and appropriate for an indefinite term, rather than the limited term ordinarily fixed, all of the oil or gas under a specified tract. Such a payment would be treated as cost to the one acquiring these rights and would be recoverable through depletion if oil was discovered, because the reserves could then be estimated and a basis for the computation established, but until oil was discovered there would be no basis for amortization on account of the lapse of time and the

using up on that account of a portion of the rights granted.

We submit that this case throws no light whatever upon the correct treatment by a lessee of royalties paid in cash or kind as minerals are produced or any other such current payment.

The third case cited is *Baton Coal Company v. Commissioner of Internal Revenue*, 51 Fed. (2d) 469, by the Third Circuit Court of Appeals, decided July 28, 1931, under the Revenue Act of 1926. The taxpayer there had entered into a lease on coal lands to extend until all of a certain vein of coal had been mined and removed. For this lease the taxpayer made a down payment of $50,000.00 and obligated himself unconditionally to pay and did pay a further sum of $51,250.00 in the succeeding year, and further agreed to pay a royalty of 13c per ton, with a minimum annual payment of $26,000.00, to pay all taxes and to account to the lessor for one-half of the net profits. The $50,000.00 payment was made in 1926; the $51,250.00 payment in 1927. The lessee taxpayer sought to deduct these payments as business expenses during the respective years of payment. The Commissioner denied these deductions:

> "• • • • • and apportioned the entire sum throughout the life of the lease, ascertained by taking the petitioner's estimate of the total tonnage of coal in the ground and dividing that by the average tonnage of coal taken out per year. He gave as his reason therefor that those amounts represented a bonus 'paid in connection with the at-

taining of the lease and should be capitalized and the cost recovered over the life of the asset'."

The Board of Tax Appeals upheld this view, as did the Circuit Court. That Court said:

> "It is clear that the payments of $50,000.00 in 1926 and $51,250.00 in 1927 did not constitute rental payments for these respective years, but together represented the payment of a bonus or rental in advance for the entire term of the lease, the length of which was determinable by the quantity of coal in the ground divided by the annual average output. The lease was to run until exhaustion of the coal. It is clearly evident, therefore, that those sums, together with the other payments specified in the lease, constituted the consideration for a lease during the entire period, and that, under the law and the regulations, those sums must be apportioned as an expense over the whole term of the lease, and are not deductible as a business expense of the years in which they were paid. Duffy v. Central R. Co., 268 U. S. 55, 45 S. Ct. 429, 69 L. Ed. 846; Galatoire Bros. v. Lines (C. C. A.), 23 Fed. (2d) 676."

Here the treatment accorded these cash payments followed exactly the treatment which has always been accorded the bonus paid for oil and gas leases. It is income to the lessor, cost to the lessee, recoverable over the life of the lease through depreciation or amortization. Here, too, the payments were treated in exactly the same way as Perkins treated the $155,000.00 in cash and notes which were paid to Branson & Hammond. But in the *Baton Coal Company* case, in the

case of the ordinary oil and gas lease, and, we say, in the Perkins case here, the ordinary royalties, the minimum annual royalties, or those sums equivalent to ordinary royalties involved in this case are deductible as an expense in the year involved if they ever reach the income of the lessee, and nothing in the *Baton Coal Company* case hints to the contrary.

The case of *Jefferson Gas Coal Co. v. Commissioner of Internal Revenue*, 52 Fed. (2d) 120, decided by the Third Circuit on August 19, 1931, was the next case cited by the Eighth Circuit Court in the *Comar Oil Company* case.

There the question involved was whether the instrument under consideration was actually a lease or was a contract of sale. It was executed in 1920. It covered coal lands. It provided for ten annual payments arrived at by fixing a so-called royalty of 12c per ton upon a minimum tonage sufficient to produce each year $31,000.00. If the so-called lessee did not mine that tonnage, it was nevertheless required to pay the specified sum. If it mined more, the additional royalty, so-called, of 12c was to be paid, but this excess payment was to be credited upon the total fixed obligation of $310,000.00. And when the so-called lessor received a total of $310,000.00, he was obligated, for an additional consideration of $1.00, to execute and deliver a deed in fee simple. The question was whether or not the so-called annual royalties were really such or whether the instrument was a contract of sale so that the entire $310,000.00 should be treated as cost of the

land recoverable as any other cost and not to be deducted when paid.

The Third Circuit Court said:

> "If this contract was a lease and the annual payments of $31,000.00 were rentals, then under the act the deduction should have been allowed as claimed, but if this so-called lease was in fact a contract of sale, and the annual payments were capital expenditures, then a deduction for the value of the coal actually mined only should have been allowed."

The first portion of this quotation states a princple directly opposed to that announced in the *Comar Oil Company* case. In the *Comar* case the Court expressly stated that such rentals were not deductible. In the case under consideration the Third Circuit Court said that they were deductible if the instrument was a lease and the annual payments were rentals. The Court then went ahead to hold that the real character of the instrument should be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole, and that:

> "Looking at the instrument as a whole and the object sought to be obtained, that it is a contract of sale of coal in place and not a lease is inescapable."

Here there was a fixed enforceable obligation to pay $310,000.00 over a period of ten years, and this regardless of whether a single ton of coal had been mined from the property. This, coupled with the pro-

vision that upon payment of the sum the payor was to receive a deed, clearly distinguishes that case from the one which we are considering.

The last court decision cited in the *Comar Oil Company* opinion was that of *Davison v. Commissioner*, 60 Fed. (2d) 50, decided by the Second Circuit on July 11, 1931.

In the *Davison* case the taxpayer had in December, 1923, paid $8,000.00 for an assignment of a building lease on property which had been sublet and which could be expected to produce about $1,800.00 a year for about 2½ years. The lease so acquired expired in July, 1926, but it contained an option to purchase the property, which option the taxpayer exercised. The question presented was whether all, a portion, or none of the $8,000.00 so paid for the lease could be offset against the rentals received by Davison from December, 1923, to the expiration of the lease in 1926. The Court held that a certain portion of these payments could be so applied.

> "So much of it as represents the cost of acquiring the leasehold should be regarded as an exhaustible capital investment returnable by annual deductions spread over the term of the lease."

And it then proceeded to determine what would be a fair portion of the total $8,000.00. Here is nothing more than an application of the principle that the bonus paid to acquire a leasehold over a period of years is not to be treated as a business expense entirely applicable to the year of payment, but as to the lessee or the one

making the payment this expenditure is to be returned through annual deductions over the term of the lease.

In addition to the cases by the various Circuit Courts above discussed, the Eighth Circuit Court cited in the *Comar Oil Company* case three decisions of the United States Board of Tax Appeals.

The first of these is the case of *Charles H. Merillat v. Commissioner*, 9 B. T. A. 813. The petitioner there held certain oil and gas leases on Indian lands in Oklahoma under which he was required to pay annually, in lieu of drilling and producing from the particular tract, certain payments based on acreage, sometimes referred to as advance royalties and sometimes referred to as rentals. These payments he claimed to be deductible in the year when made. This contention was allowed and in allowing it the Board reached a conclusion directly at variance to that reached by the Court in the *Comar* case. The Board said:

> "We are of the opinion that the total payments of $1,203.45 itemized in the findings of fact constitute rentals and as such are deductible under section 214(a) (1) of the Revenue Act of 1921, which provides that in computing net income there shall be allowed as deductions rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> "Some of the payments were termed in the leases as 'advanced royalty' and by the express pro-

visions of the leases they could not be credited against any production other than that of the current year. Under such circumstances, we believe the amounts paid as such are deductible in the current taxable year."

Here the Board treated as deductible payments which were termed advanced royalties, even though the customary rule as to the ordinary bonus or advanced royalty is, in so far as lessee is concerned, to capitalize same and recover it through amortization or depletion. This distinction is made because such advanced royalties could only be applied against ordinary royalties, if any there were, during the current year. So in our case, if we treat the amounts received by Branson and Hammond as coming from Perkins rather than from the property itself and from the sale of the oil by them, as we contend should be done, such payments would be deductible because they relate to current operations and confer no benefit directly related to either later or earlier years. In this sense they could constitute one of the ordinary burdens of current operation.

The next Board of Tax Appeal case is *Kekaha Sugar Co., Ltd. v. Commissioner*, 13 B. T. A. 690. This taxpayer was a Hawaiian corporation engaged in the business of growing sugar. It leased land for this purpose. Its lease provided that the rental should be paid in sugar, but it was customary for the lessee to market the sugar and pay the lessor the market value. It seems that the planting, cultivating and harvesting of the sugar cane extended over three years. In 1918 a large sum was paid as rental, 1/3rd of which was charged to

the crop harvested that year and the other 2/3rds in equal amounts to the crops harvested in the two succeeding years. The Board had for consideration the propriety of allowing the taxpayer to deduct in 1920 1/3rd of the rental which it had paid in 1918. It refused to allow this to be done saying:

> "We are of the opinion that the rental is a direct charge against the crop from which it is paid and is deductible as a part of the cost of that crop. It follows that the Commissioner was correct in refusing to allow a deduction in 1920 of $38,053.22 of the amount paid in 1918, and in refusing to allow that amount to be included in earned surplus as a part of the cost of the 1920 crop."

If an analogy can be found between sugar and oil it would seem that this decision supports the position that all oil delivered by Perkins for the account of Branson and Hammond constituted a direct charge against operation for the year in which delivery was made. It does not even tend to support the proposition in respect to which it was recited by the Eighth Circuit, that is, that rentals and royalties paid by the lessee are a part of his gross income and that the custom has been to include them as such for tax purposes, and that oil royalties paid are customarily included as a part of the gross income of the lessee.

The last case cited was *W. P. Ferguson v. Commissioner*, 20 B. T. A. 130. This case involved three questions. One was whether or not the bonus received by Ferguson for oil and gas leases made by him on

lands owned by him and located in Texas should be taxed as ordinary income or as capital gain. The Board held that such bonuses were to be taxed as ordinary income. This case went to the Circuit Court of Appeals for the Fifth Circuit before the *Harmel* case reached that Court, and the Board's decision upon this phase of the case was reversed by the Fifth Circuit. The Government did not seek a further review of the question. Later the Fifth Circuit reached the same conclusion in the *Harmel* case, and it was brought before this Court, where the view of the Board to the effect that such bonuses constituted ordinary income to the lessor was upheld.

The second question was whether or not the bonuses which Ferguson so received and ordinary royalties received constituted separate or community income, the land covered by the leases and from which the royalties were derived being Ferguson's separate property. The Board held, primarily upon the authority of *Stephens v. Stephens*, 292 S. W. 290, a decision by a Texas Court of Civil Appeals, that such royalties and bonuses constituted separate property because under Texas law they represented a sale of a part of the corpus of the property rather than revenue therefrom. This portion of the decision was affirmed by the Circuit Court of Appeals for the Fifth Circuit. It is interesting to note that on this phase of the case, that is, in determining to whom certain property or income belonged, the Board and Court applied the State law, but when the question was as to how that income was to be taxed to the person to whom it belonged the Board and

this Court disregarded State rules and looked to the Taxing Act in order to determine that question.

The third question involved in the *Ferguson* case related to the earned income credit to which he was entitled. It can have no possible application here.

No where in the opinion is there any discussion as to how royalties or bonuses paid by a lessee, or one similarly situated, are to be treated in such a one's tax return. That is the question with which we are here concerned and with which the Court was concerned in the *Comar* case. And here again is another citation which does not support the proposition under which the Eighth Circuit Court of Appeals cited it.

APPENDIX C

The distinction which the Bureau of Internal Revenue attempts to make between assignments such as those involved in the case at bar and others is illustrated by the following excerpts from a revenue agent's report made after a customary and routine examination of a taxpayer's return and its books and records. This particular taxpayer was Pace Petroleum Company, Inc., a Texas corporation, with its office in Wichita Falls, Texas. On June 14, 1934, it and a co-owner of certain oil and gas leases covering lands in Texas executed an instrument sufficiently described by the following excerpts:

> "We, F. P. Pace, as the owner of an undivided 1/8 interest in the property hereinafter described, and Pace Petroleum Company, Inc., a corporation duly incorporated as such under the laws of the State of Texas, as the owner of a 7/8 interest in the property hereinafter described, for and in consideration of the sum of $249,000.00, cash in hand paid, receipt of which is hereby acknowledged, and subject to the reservation of oil as hereinafter set out, have bargained, sold, transferred and assigned, and by these presents do bargain, sell, transfer and assign, unto Fain-McGaha Oil Corporation, a corporation duly incorporated as such under the laws of the State of Texas, the following described oil and gas leases and leasehold estates, etc."

There followed a description of the leases and the lands covered thereby, and immediately thereafter was the following paragraph:

"Notwithstanding any of the above, there is hereby reserved by the grantors and not conveyed 7/16 of the oil to be produced from the above described oil and gas leases (1/8 thereof as the property of and for the benefit of F. P. Pace, and 7/8 thereof as the property of and for the benefit of Pace Petroleum Company, Inc.) until there shall have been received by the grantors from said 7/16 of the oil, based upon its posted market value as of the date sold to the pipe line company or companies taking the oil, a sum equalling $225,000.00, plus a sum equalling interest at the rate of six per cent per annum, computed on the unpaid balance upon said $225,000.00 at the end of each calendar month * * * if and when the grantors, their heirs, successors, executors, or assigns, shall have received from said oil reservation said sum of $225,000.00, net, plus said item equalling six per cent interest, calculated as above, then all further rights of the grantors shall immediately and ipso facto cease."

As to this transaction the revenue agent said in his report:

"During the taxable year taxpayer sold the Arnold and Green leases in Archer County, Texas, to Fain-McGaha Oil Corporation. The consideration received was, for this taxpayer's 7/8 of the working interest $410,375.00, payable, $217,875.00 cash and $192,500 in oil from 1/2 of the production of the leases. The $192,500.00 payable in oil appears to be a true reservation of oil in place."

The engineer revenue agent who reported upon the

engineering and depletion questions involved in the transaction said in his report:

> "As taxpayer did not sell all of its interest in the property, the cost should be allocated between the part sold and the part retained. As the part retained is 1/2 of the oil (it appears to be equivalent to an overriding interest, due to the size of the payment), 1/2 of the cost is allocated to the part sold and 1/2 to the portion retained. See R. A. R. for computation of the profit on this sale on the above basis. The taxpayer is entitled to percentage depletion on the income from the reserved interest, such depletion being in excess of depletion based on the cost of this interest."

Thus it will be seen that the Bureau of Internal Revenue makes most important distinctions in the treatment of transactions which, from a practical standpoint, cannot be distinguished. Under one type of instrument the Bureau readily grants the holder and recipient of the oil payment depletion with respect thereto and excludes the proceeds from the sale of the oil applicable to the oil payment or reservation from the income of the operator. In the other type of case, like that now before the Court, the Bureau of Internal Revenue tries to treat the amount received by the oil payment holder as additional consideration, denies him depletion with respect thereto—regardless of the fact that various circut courts have expressly held such oil payment holder entitled to depletion—and includes the proceeds from the oil applicable to the oil payment in the income of the operator.

Although the fact that there is no real distinction between the two types of instruments and no justification for this different treatment has been strenuously urged by the Respondents at all stages of this proceeding, the Government has never seen fit to attempt to explain or justify the distinction, and the brief filed by them in this Court follows this same policy.